

SESSION VI: PREVENTING ABUSIVE SELF DEALING

Presentation
by

Mr. Mark V. Jarvis
Director, Fleming Asset Management
Russia

A CASE STUDY - EAST OF MOSCOW¹²

Introductory Comments

The following text is a summary of a situation well outside of Moscow, which I believe may provide some examples in a general manner of Abusive Self Dealing traits expanding some of the issues that my colleague from KPMG has discussed in concept.

The example I will cover unfortunately includes examples of:

- ◆ Problems resulting from privatisation
- ◆ Issues of suppliers being related companies (trading relationships)
- ◆ Transfer pricing
- ◆ Abuse of pre-emption rights
- ◆ Abuse of shareholder rights
- ◆ Lack of bankruptcy implementation

The example is of an investee company that we looked at investing in but with good judgement and more than a little luck did not.

AN EXAMPLE - THE DAIRY INDUSTRY

Background

This particular Oblast (region) of Russia is medium sized and located in the middle of Russia. In the Oblast there are three Dairy factories which were privatised in the early 90's during the mass privatisation plan. The result was a number of factories which were owned by management and the employees.

Over time the prospects of each company deteriorated and the employees despondent. This led, as in many similar companies throughout Russia, to the management and Director General offering to buy the workers share for nominal amounts in an act which was seen as one of good faith to help the employees.

This led to, in our case, a factory in which the General Director had direct control of 56% of the stock, management 9%, workers 7% and other local companies 28%. The other two dairy factories in the Oblast were similarly privatised. The larger of the three based in the capital of the Oblast was controlled by management and not solely the Director General, the third factory had a similar fate to that of our example.

The Process

¹ The example has been substantially changed from the factual position for legal reasons.

² The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries. This paper is subject to further revisions.

Overtime (approximately 2 years) the Dairy industry collapsed substantially in this Oblast. Our dairy factory was far less efficient than the one in the Oblast capital though better than the third. Nevertheless the milk production in the region collapsed since the dairy cattle stock was simply eaten.

This imports from the neighbouring Oblast to the South which has a sufficiently better climate to our example generated surplus milk available for local export.

Our milk factory could not always pay on time and entered into contracts where shares would be sold at nominal value to the suppliers when cash was not available.

By the time we began to look at the company as a possible investment the doomed structure was already in place.

On the surface the company appeared to be working well, staff were paid almost always on time, the factory was clean, milk was in stock and products were produced. Equally importantly the products of the company had a good reputation locally - surely a possible investment target.

What was really happening?

By the time we started looking at the company in detail the main problems we encountered were:

- ◆ **Control.** The Director General was also the major shareholder with 56% of the stock not a problem in itself although abuse was looming.
- ◆ **Share Swaps with Suppliers.** The Director General had to enter into unusual deals to obtain milk which allowed suppliers to swap their debts for shares in the dairy factory when the factory had no cash.
- ◆ **Pre-emption Rights Abuse.** How was this possible? This was a close JSC with 75% pre-emption rights. Simple the Director General had 56% of the votes and let it be known that any employee or manager who didn't vote "for" would not be working at the factory the next day. Together that totalled 72% and with a few friends 75% was easy.
- ◆ **Abuse of Shareholder Rights (Profit Diversion).** One of the Director General's friends was a trader of commodities such as meat, clothes, etc. importing such from China, Romania, etc. This friend was building a hotel which needed investment - our cash strapped Dairy Factory invested money in the hotel on the basis that the friend would source packaging supplies. The General Director sourced treasury stock from the employees at nominal value and sold it on the 3rd party at NAV. Since the company was well equipped the NAV was high.
- ◆ **Transfer Pricing.** Of course the inevitable transfer pricing was also present. The factory had two key needs: milk and packaging. Packaging was available from Eastern European supplier who wanted cash up-front. Our factory had no cash: so it bought through a local distributor which was not the cheapest in the region but, and by now you have probably guessed it, was partially owned by our Director General. We estimated the overpriced packaging cost the company approximately \$300,000 a year on a total need of \$2,500,000 of packaging, i.e. inflating costs by 13%.
- ◆ **Minority Shareholders Interests Ignored.** With the increase in the economy in '97 the factory in the city became more prosperous. It wanted to expand and offer to buy out the Director General and the management in our example. However, despite this being a good offer which would of course benefited all normal shareholders, since the Director General had other interests it was turned down.

The director General again used the threat of redundancy unless the staff and management voted in favour of rejecting the offer. Why? Well, the Director General was making more money out of a bankrupt or near bankrupt factory than he would from selling his shares.

- ◆ **Asset Stripping ?.** We could not see blatant asset stripping but an interesting twist was a sports hall and tennis court that was built with the company's money. The Director General then turned it into a private club which local "businessmen" paid him money to use.

What are the major issues to note here and how can they be tackled?

- ◆ Bankruptcy legislation is in place and is not enforced. My view is that if bankruptcy legislation was properly enforced in this example at least one issue could have been solved:
 - Minority investors could have been protected to some extent in the latter stage by the sale of the company to its larger and more financially strong competitor.
- ◆ I agree with my colleague from KPMG what the market experience of managers in small and medium size companies is still new - one must remember that 10 years ago 'entrepreneurial business' was illegal under the Communist regime.
- ◆ The concept of "for whom the company is run" has not developed and shareholders are generally not in charge of companies: management has the upper hand and rarely consult with shareholders.
- ◆ The companies are generally under regulated by management and the shareholders but there may be some good (or rather bad) reason for this which could be one of the examples set out above.
- ◆ There is no short, sharp, quick route. The larger companies are generally beginning to consult shareholders since market value is paramount.
- ◆ Small to medium size enterprises are far from being run for the shareholders and in our view will change slowly overtime as the benefits of returning shareholder values is seen.
- ◆ The courts must be seen to support the law and, in the event that the current presidential poll leader, Acting President Putin wins his strong management style should be able to control the courts. Mind you I work in Russian and therefore an habitual optimist.
- ◆ Other initiatives like the Investors Co-ordination Centre can help to lobby changes but do not be mistaken in thinking that it will change quickly.